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Shannon Guy
University of Michigan Law School

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REGULATION OF PRIVATE EQUITY IN BRAZIL: POLICY QUESTIONS PRESENTED AND CRITIQUE

*Shannon Guy**

I. INTRODUCTION

This note is the second part of a two-part publication that introduces and critically evaluates Brazilian private equity market. Over the past ten years, Brazil's private equity market has expanded rapidly and appears poised to grow even more in the future.[1] A basic understanding on the players, regulators, and laws that define the Brazilian market is important for any private equity practitioner. Part I of my publication titled *Private Equity in Brazil: Industry Overview and Regulatory Environment*[2] introduced the private equity industry in Brazil. In that note, I discussed Brazil's main regulators, the Brazilian Securities and Exchange Commission (the "CVM"), and three self-regulators: the Brazilian Association of Entities in the Financial and Capital Markets (*Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais,* or "ANBIMA"); The Brazilian Association of Private Equity and Venture Capital (*Associação Brasileira de Private Equity e Venture Capital* or "ABVCAP); and BM&FBOVESPA, the São Paulo Stock Exchange. I also analyzed the regulations governing a private equity investment vehicle over the lifetime of a private equity investment. Notably, Brazil has taken a relatively, "hands off" approach to private equity regulation.[3] This second note, Part

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1. Key to this increased private equity activity was Brazil's ability to: (1) promote macroeconomic stability by reigning in inflation; (2) the government's overt encouragement of private equity funds through the creation of the FIP (*Fundos de Investimento em Participações*) investment form; (3) the reduction in capital gains taxes associated with private equity investments; and (4) the changes in regulatory policies that allowed Brazilian pension funds to invest directly in private equity investment vehicles. Shannon Guy, Note, *Private Equity in Brazil: Industry Overview and Regulatory Environment*, 2 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 155, 158-160 (2012) [hereinafter *Private Equity in Brazil*].

2. *Id.*

3. In general, Brazil has encouraged investment in private equity vehicles by allowing vehicles to organize as a limited partnership under the laws of another country (typically the U.S. and under the laws of Delaware), and by creating a special type of private equity investment vehicle—the FIP—with tax benefits substantially similar to the limited partnership form enjoyed in the United States. I found that the Brazilian Government has successfully

II of my two-part publication builds on my earlier analysis by addressing the policy questions raised by Brazil's regulatory regime. This note also provides a critique of Brazil's current policy and practices for regulating its private equity market.

In this note, I explore some of the policy questions affecting Brazil's private equity industry that the country must tackle. In Part II, Section A, I begin by asking the threshold question of whether the Brazilian government should play an active role in encouraging the growth of the private equity industry. I resolve that Brazil should play an active role in encouraging the industry's growth to encourage several possible benefits to the real economy. Private equity may benefit the economy by providing job growth and job preservation, improved access to credit for firms that would not otherwise have funds, and improved access to talented managers. Further, private equity may be an effective screening mechanisms for selecting good companies. In Part II, Section B, I ask whether Brazil has successfully encouraged the growth of the private equity industry, or has set policies that stifle its growth. By applying Ribeiro et al.'s "supply" and "demand" factors, which lead to private equity growth in the Brazilian context, I conclude that Brazil has done a commendable job creating a regulatory environment that bolsters the growth of the private equity industry, but that lowering interest rates and the costs associated with starting a business would help the industry to expand further. In Part III, Section C, I ask whether the Brazilian government should play an active role in regulating its nascent private equity industry, and conclude that Brazil should proactively regulate the industry, in certain areas, because the benefits of good governance outweigh the costs associated with added regulatory compliance. In Section D, I ask which actors are best suited to create and enforce private equity regulations—government agencies or self-regulating agencies. I conclude that the Brazilian Securities and Exchange Commission does not, at present, provide sufficient oversight of the private equity industry, and that the self-regulatory agencies, like ANBIMA, ABVCAP, and BM&FBOVESPA cannot adequately enforce their own regulations due to conflicts of interest.

In Part III, I critique Brazil's current regulatory policies. I ask which risks Brazilian regulators should focus on mitigating, and try to assess their

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encouraged private equity investment through FIPs, but the FMIEE, an investment vehicle for venture capital, has been less successful. Given the importance of venture capital to market dynamism and prosperity, I recommend that Brazil reassess the incentives it provides to the FMIEE fund structure. I also found that Brazil has effectuated the necessary investor protections to encourage investment in portfolio companies, noting that investors need to rely on arbitration as opposed to the Brazilian courts to enforce their rights. Accordingly, I recommended that Brazil improve its legal system's efficiency and predictability to encourage more investment. I found that the regulations related to management of the private equity investment are sparse and limited to the requirement to disclose information related to the companies' financial position. Finally, I found that Brazil has laid the regulatory groundwork to encourage viable exit opportunities by allowing companies to pick and choose their ideal level of corporate governance using the São Paulo Stock Exchange's *Novo Mercado* model. *Id.*

effectiveness at regulating each risk. In eight sections, I explore different risks that a robust private equity industry could pose for Brazil: (1) increased leverage in the capital markets, (2) market abuse problems, (3) conflicts of interest, (4) transparency risks, (5) overall market efficiency risks, (6) market access risks, (7) systemic risk to capital markets, and (8) risks for qualified investors. I conclude that of these risks, Brazilian regulators should focus primarily on market-abuse risks, conflicts of interest, and transparency issues, and that, at present increased regulation for the other enumerated risks is either unnecessary or impractical.

Part IV Concludes.

II. Regulatory Policy Questions Presented

This section explores policy questions raised by the private equity industry in Brazil. In four sections, I ask (1) whether the government should seek to build up the private equity industry, (2) whether governmental policies have fostered growth effectively, (3) whether the government should actively regulate the industry, and (4) whether the government or self-regulating entities are better poised to set and enforce regulations. I make four conclusions. First, Brazil should encourage the growth of the private equity industry. Second, while Brazil has set the groundwork for a private equity industry to grow, it must take additional steps, like cutting interest rates, to ensure continued growth. Third, Brazil should actively regulate its nascent private equity industry. Lastly, neither governmental regulators nor self-regulatory organizations are presently adequate to set and enforce industry regulations in Brazil.

A. *Should Brazil actively foster the growth of the private equity industry?*

The Brazilian Governments should play an active role in fostering the development of a robust private equity industry, including developing a strong market for venture capital investments.[4] Doing so could create jobs, contribute to the real economy, provide increased access to credit for many companies, improve access to talented employees, and serve as a screening mechanism for quality companies.

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4. As discussed in *Private Equity in Brazil*, private equity and venture capital are sometimes treated as separate industries, as venture capitalists tend to invest in start-ups and small businesses, whereas Private Equity firms tend to invest in larger, more established companies. However, venture capital may be considered a subset of the private equity industry generally, and this is the approach taken in this paper. *Private Equity in Brazil*, *supra* note 1 at 156 n 4. *See also* Eur. Priv. Equity & Venture Cap. Ass'n., *Guide on Private Equity and Venture Capital for Entrepreneurs* (2011), *available at* http://www.evca.eu/entrepreneur/default.aspx?id=3540.

1. A robust Brazilian private equity industry could increase job growth and long-term job preservation and contribute to growth in the real economy

Brazil should bolster its private equity industry, because doing so could create jobs, preserve jobs in the long-term, and contribute to growth in the real economy. The U.S. experience suggests that private equity backing for companies creates jobs and increases revenue. A study by DRI-WEFA, published by the National Venture Capital Association, found that between 1970 and 2000, venture-capital-backed portfolio companies directly employed more than 12.5 million people in the U.S. and contributed nearly $1.1 trillion to U.S. GDP in the year 2000.[5] When companies that provided supporting services, such as delivering goods and services, to the portfolio companies were included, the figure rose to 27 million jobs.[6] The study found that, on average, every $36,000 in venture capital investments created one new job.[7]

Job creation and revenue increases associated with a vibrant private equity and venture capital industry could benefit small and mid-sized businesses in Brazil. Pagglia and Harjoto (2012) found that small and mid-sized businesses in the U.S. that received a private equity or venture capital investment created more jobs and raised more revenue in the five years after the financing event than a control group.[8] In a 1995 to 2009 study analyzing 6,815 small and mid-sized businesses, firms that received private equity investments experienced, on average, 129 percent more revenue growth and 257 percent more employment growth than their non-VC-backed counterparts. At the end of five years, those companies that received private equity investments created an average of 36 more new jobs than did control counterparts. Firms that received venture capital investments created, on average, 127 more new jobs compared to control counterparts.[9] Firms that received venture capital investments had approximately $24.7 million higher annual net sales per establishment five years after the financing event, compared to the control group. For firms with private equity financing, net sales were on average $6.9 million higher per establishment five years after the financing event than for the control group.[10] The American experience suggests that developing a strong private equity and venture capital industry may help Brazilian companies create jobs and increase revenue.

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5. Press Release, The Nat'l Venture Capital Ass'n, DRI-WEFA Study Identifies Venture Capital as Key Factor Powering U.S. Economic Growth (June 26, 2002), *available at* http://www.prnewswire.com/news-releases/dri-wefa-study-identifies-venture-capital-as-a-key-factor-powering-us-economic-growth-77986182.html (citing DRI-WEFA, Measuring the Importance of Venture Capital and Its Benefits to the United States Economy, June 19, 2002).

6. *Id*.

7. *Id*.

8. *Id.*

9. *Id.*

10. *Id.*

Even if Brazil could not perfectly replicate the American experience, having a vibrant private equity and venture capital industry would, at a minimum, create jobs at least for those employed to manage the funds, and also for the companies which receive investments. While it is true that private equity firms often take over companies and lay off personnel in an effort to cut costs, such measures could also lead to the ultimate preservation of the company and its return to profitability, thus saving jobs in the long run which would have been eliminated if the company were left to fail.[11]

Clearly, then, a strong private equity industry might help Brazilian companies create jobs and increase revenue, for both large and small companies. Further, a robust private equity industry could help preserve jobs already existing in Brazil, and contribute to the real economy in the long run, by taking declining companies, which would otherwise have gone out of business, and turning them into more profitable firms.

2. Private equity could increase access to credit for Brazilian companies

Brazil should encourage private equity activity to bridge financing gaps for Brazilian companies which might not otherwise have access to credit. Start-ups and small and medium enterprises frequently suffer from an inability to obtain credit through traditional modes of financing.[12] A survey conducted by the European Commission in collaboration with the European Central Bank found that, after finding customers, access to finance was the second most pressing problem faced by European Union small and medium enterprises.[13] Similarly, surveys by the National Federation of Independent Businesses (NFIB) between 2009 and 2011 found that, among small businesses, the larger the small business, the more likely such business had access to traditional lending through credit or business term loans. However, during the recent financial crisis, the rates of this type of financing declined across the board among small businesses.[14] This trend is to be expected, generally, small to medium enterprises suffer from less access to credit because these businesses are seen as more risky and more costly than larger firms, and have higher failure rates.[15] Brazilian start-ups and small businesses have an even more difficult time finding funding than companies in more developed economies, because debt in Brazil tends to

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11. *See* N. Robert Hammer, *Private Equity Isn't About Greed, It's About Growth*, FORBES (Jan. 11, 2012, 2:37 PM), http://www.forbes.com/sites/ciocentral/2012/10/11/private-equity-isnt-about-greed-its-about-growth/.

12. SME's Access to Finance: Survey 2011, Short Summary at 1, European Commission Enterprise and Industry, *available at* http://ec.europa.eu/enterprise/policies/finance/files/2011_safe_summary_en.pdf.

13. *Id.*

14. BD. OF GOVERNORS OF THE FED. RESERVE SYS., NO. 0912, REPORT TO CONGRESS ON THE AVAILABILITY OF CREDIT TO SMALL BUSINESSES 1 (2012), *available at* http://www.federalreserve.gov/publications/other-reports/files/sbfreport2012.pdf.

15. *Id.* at 17.

be more expensive.[16] This lack of access to financing is a primary reason that start-ups fail in Brazil.[17] Private equity and venture capital funds can solve this financing gap by providing companies with an infusion of capital in exchange for a share of the upside and downside risks associated with the investment.[18]

Private equity could also solve financing gaps in Brazil for large and established companies that need an infusion of capital to continue growing.[19] Sometimes, traditional lenders may be reluctant to lend at terms agreeable to companies due to their aversion for risk.[20] For example, in Europe some firms have turned to private equity investments when banks turned them down, or provided less favorable lending rates.[21] When this is the case, private equity can step in to fill the financing gap, charging higher interest rates for loans that banks are unwilling to make.[22]

3. Private equity could help Brazilian companies increase business know-how and attract talented managers

A robust private equity industry in Brazil could help Brazilian companies increase profitability by increasing business know-how at companies that receive funding. Since private equity funds usually take an active role in managing and overseeing their portfolio companies, they could provide knowledge and expertise, monitoring and performance tools, consultation regarding best-case-practices, opportunities for networking, mentoring from other successful entrepreneurs, and introductions and appointments for a companies' board of advisers. These types of management benefits could help Brazilian companies grow, increasing prosperity in the real economy. By providing companies with expertise, private equity firms could help companies pass the benefits of such better management on to consumers in the form of better quality and lower cost products.

A private equity industry could also help Brazilian companies attract talented managers. Brazilian companies have a hard time recruiting top talent.[23] A 2012 Survey by the ManpowerGroup found that Brazil had a

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16. Tales Andreassi & Eduardo Madureira Rodrigues Siqueira, *The Funding of New Technology-based Firms in Brazil*, 6 INT'L. J. ENTREPRENEURSHIP & INNOVATION MGMT. 369, 370–373 (2006).

17. *Id.*

18. Dirk Engel, *The Impact of Venture Capital on Firm Growth: An Empirical Investigation* 1 (Centre for Eur. Econ. Res., Discussion Paper No. 02-02, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=319322.

19. *See* Anne-Sylvaine Chassany & Jesse Westbrook, *Private Equity Enters Banks' Turf in Europe*, BLOOMBERG (Feb. 8, 2012, 7:01 PM), http://www.bloomberg.com/news/2012-02-09/lending-void-draws-buyout-hedge-funds-to-banks-turf-in-europe.html.

20. *Id.*

21. *Id.*

22. *Id.*

23. MANPOWERGROUP, 2012 TALENT SHORTAGE SURVEY RESEARCH RESULTS 4 (2012), *available at* http://www.manpowergroup.us/campaigns/talent-shortage-2012/pdf/2012_Talent_Shortage_Survey_Results_US_FINALFINAL.pdf.

harder time attracting talent than any other country in the Americas. Seventy-one percent of surveyed employers found it difficult to find employees that were qualified for their available jobs.[24] Having a robust private equity industry could help fill this management shortage by encouraging talented foreign financial service managers to travel to Brazil to teach Brazilian managers better skill sets. The industry could also help provide funds and advertising to attract domestic and foreign new hires to work directly in management positions with Brazilian companies and invest in on-the-job training in the form of seminars or career development courses.[25]

4. Private equity may help screen good companies in Brazil

A strong private equity industry could help contribute to stability in the Brazilian real economy by filtering out companies that are not poised to succeed. Since private equity and venture capital investors are adept at analyzing the value propositions of various companies, they ideally serve as a "screen" for bad ideas or bad managers and aim to provide capital only to those companies that are best-poised to succeed.[26] Tavares conducted a statistical study of companies that conducted IPOs in Brazil between January 2004 and February 2007 and found that those companies that received private equity funding were more likely to survive after one year.[27] Tavares concluded from these results that private equity investment acts as a "quality certification" for IPOs in Brazil and suggested that private equity funds may have a value-creation role insofar as they prepare better portfolio companies for public market investment.[28] In other words, having a thriving private equity industry in Brazil not only benefits private investors, but also benefits public investors, who enjoy long term gains after buying stock in the company once it is turned over as a public offering.

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Because of the benefits that private equity can bring to the real economy, some scholars have concluded that every national administration should strive to promote an efficient private equity and venture capital industry.[29] Finding that, on balance, a flourishing private equity industry provides positive benefits for a country's economic prosperity begs the

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24. *Id.*

25. *See* Hammer, *supra* note 13 (describing the way that one private equity firm took over a failing company and appointed a new CEO to turn it around).

26. Pedro Carvalho Araújo Tavares & Andrea Maria Accioly Fonseca Minardi, Does Private Equity Investment Work as a Quality Certification for IPOs in Brazil? (June 14, 2010) (working paper series), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1624876.

27. *Id.*

28. *Id.*

29. *See* Andreassi & Siqueria, *supra* note 16, at 374-77.

question whether Brazil has encouraged the development of a strong and stable private equity industry.

B. *Has Brazil's governmental regulation effectively encouraged the private equity industry?*

Brazil has effectively encouraged the growth of the private equity industry, by maintaining a regulatory environment that encourages both supply and "demand" for private equity activity, but a further reduction in interest rates would be beneficial for the continued growth of the industry. As described by Gompers and Lerner in their research on the growth of private equity industries worldwide, a private equity industry's size depends on "supply" factors related to the number of investors willing to commit money to private equity ventures, and "demand" factors related to the number and quality of entrepreneurs and businesses seeking capital.[30] Synthesizing findings from industry experts, Ribeiro et al. explain several factors which increase "demand" in the private equity market, (i.e. the number of entrepreneurs and businesses seeking more capital), and others factors which increase "supply," (i.e. the number of investors willing to dedicate money to private equity funds).[31] Here, I take the demand-side and supply-side factors identified by Ribeiro et al. and assess whether Brazil's government has sufficiently fostered an environment that allows the private equity industry to grow, and whether tweaks to the regulatory environment are needed to promote industry growth. I conclude that overall, Brazil has done a commendable job of cultivating both supply and demand for a flourishing private equity industry, but that further reductions in interest rates are advisable for the industry's continued growth.

1. Demand-side factors leading to increased private equity activity

Factors identified by Ribeiro et al. that create "demand" for a private equity industry are: (1) a reduction in capital gains taxes, (2) increases in entrepreneurship activity, (3) increases in "innovative efforts," and (4) reductions in interest rates. Brazil has successfully encouraged all four of these demand-side factors, but a further reduction in interest rates would be highly beneficial for the continued growth of the industry.

a. *Reductions in capital gains taxes*

Since private equity investments are taxed at capital gains rates, a reduction in the capital gains tax over time encourages investors to make

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30. Paul A. Gompers & Josh Lerner, *What Drives Venture Fundraising?*, Brookings Papers on Econ. Activity (Microeconomics Issue), 1998, at 150, *available at* http://www.brookings.edu/~/media/Projects/BPEA/1998%20micro/1998_bpeamicro_gompers.pdf.

31. *See* Leonardo de Lima Ribeiro et al., Private Equity and Venture Capital in an Emerging Economy: Evidence from Brazil 2 (2006), *available at* http://gvcepe.com/site/wp-content/uploads/2011/12/pevc_in_an_emerging_economy_evidence_from_brazil.pdf.

private equity investments.[32] Brazil has progressively reduced its capital gains tax rate for private equity investments by encouraging investment in a special fund form, created specifically for private equity, called the "FIP" (*fundos de investimento em participações*). The move towards increased investment in funds structured as FIPs as opposed to holding companies is discussed at length in *Private Equity in Brazil*.[33] Two significant differences between the holding company structure and the FIP structure demonstrate why investors generally prefer to structure private equity investments as FIPs. First, profits under a holding company structure are taxed at a much higher level than those that are generated under the FIP form.[34] While the FIP itself need never pay a capital gains tax, holding companies must pay a 34 percent capital gains tax for the sale of equity investments held by the holding company.[35] While Brazilian FIP investors pay, individually, a 15 percent capital gains tax when they redeem their FIP quotas, Brazilian holding company investors pay a 20 percent capital gains tax on any capital gains from their investments.[36] International FIP investors that hold less than 40 percent of a FIP's quotas pay no capital gains taxes whatsoever, and those who hold more than 40 percent pay a 15 percent capital gains tax. International investors that invest in holding companies pay a 15 percent capital gains tax regardless of the size of their investment in the fund.[37] In addition to this unfavorable tax treatment, while the FIP form allows write-offs in case of losses, only in limited circumstances may holding companies write off losses due to unsuccessful investments.[38] The result is that investors prefer using and increasingly turn to the FIP as a vehicle for investment. Surely then, the creation of the FIP investment vehicle for private equity funds, with its associated reduction in capital gains taxes, demonstrates that Brazil has created a vehicle that boosts the demand for a vibrant private equity industry. If Brazil were to lower its capital gains treatment further, for both FIPs and holding companies, it would likely stimulate demand for private equity investments even more, because investors respond quickly to tax incentives.

32. *See id.*

33. *See Private Equity in Brazil*, *supra* note 1, at 167-71.

34. *See* Antonio Gledson de Carvalho et al., *Private Equity and Venture Capital in Brazil: an Analysis of its Recent Evolution* 7-8, (Getulio Vargas Foundation, Working Paper No. G24, 2012), *available at* http://ssrn.com/abstract=1996729.

35. GVcepe et al., The Private Equity and Venture Capital Industry: Second Brazilian Census 70 (1st ed., rev. Mar. 2012), http://gvcepe.com/site/wp-content/uploads/2011/11/The-PEVC-Industry-Second-BR-Census-1ed-Revised-March-2012.pdf.

36. *Id.*

37. *Id.*

38. De Carvalho et al., *supra* note 34, at 7.

b. *Increased entrepreneurship activity*

Entrepreneurship activity is a second demand-side factor that generally increases the number of start-ups seeking funding.[39] Brazil has an extraordinary amount of entrepreneurship activity, but whether this is due to the regulatory environment remains open to question. According to the Global Entrepreneurship Monitor ("GEM"), the largest ongoing study of entrepreneurial dynamics in the world, Brazil's entrepreneurial activity is remarkably high, and has increased in recent years.[40] The GEM measures "Total Entrepreneurship Activity" (or "TEA"), the proportion of a population between the ages of 18 and 64 years old that are involved in entrepreneurial activities or companies less than 42 months old. More developed countries generally have lower levels of TEA as more people take on service-oriented jobs.[41] Among the 17 countries in the G-20 that participated in the 2010 study, Brazil had the highest TEA, at 17.5 percent, followed by China, with 14.4 percent.[42] In absolute numbers, only China possessed more entrepreneurs than Brazil.[43]

An analysis of whether Brazil's high levels of entrepreneurship activity is more the result of its regulatory regime, as opposed to culture or other factors, is beyond the scope of this note. But, even without this analysis, it is possible to conclude from the existence of high levels of entrepreneurship activity that the regulatory regime has not squelched such activity, and has allowed it to grow. Thriving entrepreneurship activity contributes to demand for private equity activity in Brazil, because investors, especially venture capitalists, are attracted to opportunities to invest in new and profitable businesses and products.

c. *Increased "innovative efforts"*

"Innovative efforts" as measured by research and development expenditures and number of patent applications, is a third factor that increases the likelihood that entrepreneurs will seek funding.[44] Innovative efforts are a proxy for supply side growth because as entrepreneurs spend money to research, develop and patent new ideas, they then seek funding to build and market the product or idea they have developed, and capitalize on their innovation. Innovative efforts are distinguished from entrepreneurial activity, discussed above, because they focus on steps taken to promote research and development and to protect technological advances. While there have been increases in this "demand-side" factor for private equity in recent years, Brazil could do more to foster innovative

39. *Id.*

40. Global Entrepreneurship Monitor, Empreendedorismo en Brasil (2010), *available at* http://www.gemconsortium.org/docs/download/451.

41. *Id.*

42. *Id.* at 37.

43. *Id.*

44. Ribeiro et al., *supra* note 31, at 2.

efforts by spending more on research and development and decreasing the procedures and cost associated with filing a patent application.

Brazil has seen an increased demand for private equity by increasing innovative efforts, as measured by research and development over time.[45] Expenditures on research and development as a percentage of GDP has been increasing according to World Bank Data, growing from 0.72 percent of GDP spent on research and development in 1996 to 1.08 percent in 2008.[46] However, Brazil lags behind other countries, including the U.S. (2.79%), China (1.47%), and even small Slovenia (1.65%).[47] To Brazil's credit, it spent more than Russia (1.04%) and other countries in Latin America for which data was available.[48] By spending more on research and development, Brazil could contribute to the development of high-tech industries, creating jobs for skilled laborers, and also cultivate more demand for private equity investments.

Brazil saw an increase in innovative efforts as measured by patent applications in the decade before the financial crisis, contributing to demand for private equity. According to the World Bank Indicators for Technology, patent applications increased steadily in Brazil from 2000-2008, growing from 3080 applications in 2000 to 4084 in 2008.[49] However, Brazilian patent applications declined sharply after the crisis, dipping far below 2000 levels, to 2,705 in 2010.[50] Further, Brazilian patent applications lagged far behind some other countries in terms of absolute numbers and growth, during the same period.[51] The difference was most salient when comparing Brazil to China, where patent applications in 2000 were 25,346, and grew to 293,066 by 2010, without a dip in patent applications after the financial crisis.[52]

By reducing the red tape and cost associated with filing for patent applications, Brazil could encourage more individuals to patent their innovations, leading to increased innovative efforts, and more demand for private equity. According to the U.S. State Department, it takes an astounding eight years to obtain a patent in Brazil.[53] Further, according to the World Intellectual Property Organization, it costs more to obtain and maintain a patent over time in Brazil than in the United States, China, Russia, Argen-

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45. *Research and Development Expenditure (% of GDP)*, THE WORLD BANK, http://data.worldbank.org/indicator/GB.XPD.RSDV.GD.ZS?page=3 (last visited Mar. 20, 2013).

46. *Id.* (referring to data available at the time of writing).

47. *Id*.

48. *Id.*

49. *Patent applications, residents,* The WORLD BANK, http://data.worldbank.org/indicator/IP.PAT.RESD/countries/BR-US-RU-IN-CN-AR-MX?display=default (last visited Mar. 3, 2013).

50. *Id.*

51. *Id.*

52. *Id.*

53. Bureau of Econ. and Bus. Affairs, *2012 Investment Climate Statement - Brazil*, U.S. DEP'T OF STATE (June 2012), http://www.state.gov/e/eb/rls/othr/ics/2012/191115.htm.

tina, Mexico, and Italy, among others.[54] Given these sobering statistics, Brazil must reduce the time it takes to file a patent and decrease the cost of doing so to increase innovative efforts, contributing to increased demand for private equity.

d. *Reductions in interest rates*

A final demand-side factor that encourages private equity investments is a reduction in interest rates, which has a positive effect on demand for capital.[55] As discussed in *Private Equity in Brazil*, interest rates in Brazil remain remarkably high as compared to other parts of the world, making debt expensive.[56] In 2011, the lending rate was 43.9 percent in Brazil, compared to just 3.3 percent in the United States.[57] In spite of Brazil's high interest rate, it should be noted that this rate is significantly lower than it once was. In 1998, for example, Brazil's lending rate was an astronomical 86.4 percent.[58] By 2003, it had come down to 67.1 percent.[59] This data suggests that while Brazil's interest rate could stand to improve even more, the country has already started working toward improving each of the four above factors that promote demand for private equity in Brazil.

On balance, Brazil has seen improvements in all of the demand-side factors discussed by Ribeiro et al. that promote the growth of the country's private equity industry. Notably, though, Brazil has room for improvement and could increase demand for private equity further by lowering its crippling interest rates, spending more on research and development, and reducing the red tape associated with filing for patent applications.

2. Supply-side factors leading to increased private equity activity

Like Brazil's efforts to focus on demand-side factors that promote private equity in the country, Brazil has done well to improve supply-side factors for the industry. The result has led to increased private equity activity. Three such improvements include allowing public pension funds to invest in private equity vehicles, having a growing private pension fund system, and requiring private equity firms to adopt high-quality accounting standards.[60]

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54. T. David Reed, Where In the World Should I File? (2004), *available at* http://www.wipo.int/pct/en/pct_strategies/filing.pdf.

55. *See* Ribeiro et al., *supra* note 31, at 2

56. *Private Equity in Brazil*, *supra* note 1, at 183.

57. *Lending Interest Rate*, Data, The World Bank, http://data.worldbank.org/indicator/FR.INR.LEND (last visited March 20, 2013).

58. *Id.*

59. *Id.*

60. *See* Ribeiro et al., *supra* note 31, at 2.

a. *Allowing public pension funds to invest in private equity*

Allowing public pension funds to invest in private equity vehicles is one way to improve supply for private equity, because it increases the amount of money private equity funds have available to invest.[61] For example, after ERISA allowed U.S. pension funds to invest in private equity funds, the supply of funds for private equity greatly expanded, providing a boost for the industry.[62] As discussed *Private Equity in Brazil,* Brazil raised the cap on the percentage of money that Brazilian pension funds are allowed to allocate to alternative investments from two percent to 20 percent in 2009, liberating a massive amount of funds available for private equity investment.[63] In this way, Brazil stimulated supply for private equity in the country.

However, Brazil might be able to enact a few more reforms to increase the benefits associated with having this class of institutional investors. Brazilian pension funds can be involved in guiding the nature of the private equity investment, which may discourage experienced private equity investors who do not want to deal with having "too many cooks in the kitchen." Since American investors will likely be reluctant to deal with extremely active pension funds, a serious policy question arises about whether or not the active management of the pension funds is, on balance, a good thing for the Brazilian private equity industry. If it is found that pension funds are not the best managers of private equity funds and also discourage investment in Brazil, it might make sense to revise legislation which gives certain large investors (invariably pension funds) a seat on the board of FIPs. Alternatively, if it is found that the presence of pension funds presents a net benefit effect for the solidity of the private equity industry this legislation should be left standing.

b. *Increasing the size of the private pension fund market*

Another way to increase private equity in Brazil is to increase the size of the private pension fund market. When the private pension market grows, the supply of funds available to invest in private equity will also grow, especially now that Brazil has raised the cap on the percentage of money that Brazilian pension funds are allowed to allocate to alternative investments.[64] Brazil's private pension fund market is the oldest in Latin America, and is experiencing a period of rapid growth.[65] According to a 2011 Global Pension Asset Study, covering the world 13 largest pension markets, Brazil had the fastest growing private pension market between

61. *See id*.

62. *Id.*

63. *Private Equity in Brazil supra* note 1, at 160.

64. *Id*. at 170-71.

65. Adacir Reis & Leonardo André Paixão, Private Pensions in Brazil (2004), *available at* http://www.oecd.org/dataoecd/26/40/42601981.pdf.

2000 and 2010.[66] Data from the National Federation of Private Pension and Life shows that accumulated reserves in benefit plans grew from $16 billion in 2001 to $270 billion in 2011.[67] An aging population and economy transitioning from a consumer society to a savings society, along with regulatory reforms put in place by the *Plano Real,* discussed in *Private Equity in Brazil*, paved the way for the growth of private pension funds.[68] The increase in availability of private pension funds has clearly contributed to Brazil's supply of private equity investment.

c. *Adopting high quality accounting standards*

The adoption of high-quality accounting standards is a third factor which contributes to the supply of private equity investments. When countries insist that private equity funds adopt high-quality accounting standards, investor confidence is boosted, they are more willing to make investments, and the supply of funds increases.[69] Brazil has done well to adopt high quality accounting standards. Brazil's Securities and Exchange Commission, the *Comissão de Valores Mobiliários* ("CVM"), requires private equity funds to use independent auditors registered with the CVM to audit yearly financial statements and disclose information related to their financial position in accordance with international accounting standards.[70] These measures, in turn, work to improve investor confidence in the industry.

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In sum, by allowing pension funds to invest in private equity, by encouraging a larger private pension fund market, and by requiring private equity funds to maintain strong accounting standards, Brazil has successfully encouraged the supply of private equity funds.[71]

C. *Should the Brazilian government take an active stance regulating the private equity industry and reforming the judiciary?*

A third regulatory policy question, related to whether Brazil should actively *foster* the private equity industry is to what extent should the Brazilian government actively *regulate* the industry, and take steps to ensure that regulations are enforced fairly and expediently through the judiciary.

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66. Towers Watson, Global Pension Asset Study 2011, at 13 (2011), *available at* http://www.towerswatson.com/assets/pdf/3761/Global-Pensions-Asset-Study-2011.pdf.

67. Ivy Cassa, *Brazil, the Population Aging and the Market of Insurance and Private Pension*, Martindale-Hubbell (June 21, 2012), http://www.martindale.com/insurance-law/article_KLA-Koury-Lopes-Advogados_1536442.htm.

68. *Id. See Private Equity in Brazil*, *supra* note 1, at 157.

69. *See* Ribeiro et al., *supra* note 31, at 2.

70. CVM Instruction No. 391 (2003), *available at* http://www.cvm.gov.br/ingl/regu/cvm_391.ASP.

71. *See* Ribeiro et al., *supra* note 31, at 9.

Brazil should take an active stance regulating the private equity industry and take steps to improve its judiciary. Strong regulations and an efficient judiciary encourage private equity investment, whereas poor regulations and unpredictable legal structures hinder investment.[72]

Institutional factors, such as a country's quality of regulation and legal system, shape the design of the private equity industry by influencing the way investors choose to structure their private equity vehicles, and shape the extent of industry growth by influencing the amount of capital investors are willing to commit.[73] Brazil could improve its regulatory environment by (1) reforming its legal system, and (2) improving the quality of regulations.

1. Brazil should improve its legal system to encourage private equity development

A country's legal system is the paramount institutional factor influencing the design and development of private equity industries worldwide.[74] Common law countries are better poised to develop vibrant venture capital markets than civil law countries because they traditionally offer more investor protection than civil law countries.[75] Better legal systems allow for significant improvements in corporate governance among private equity and venture capital firms.[76] Specifically, systems with stronger legal protections lead to faster screening and origination of deals, a greater probability that deals will lead to syndication, better representation of investors at the board-level, lower need for capital calls prior to exit, and more investment in high-tech companies.[77] Further, valuations of companies are *positively correlated* with quality investor protection in a country's

72. *See generally, id.* at 2 (citing William L. Megginson, *Towards a Global Model of Venture Capital?*, 16 J. of Applied Corp. Fin. 89, 95 (2004)), Douglas Cumming & Grant Fleming, A Law and Finance Analysis of Venture Capital Exits in Emerging Markets (Sept. 2002) (unpublished manuscript) (on file with Austl. Nat'l Univ.), *available at* http://cbe.anu.edu.au/media/1436976/finm0028wp.pdf; Douglas Cumming et al., *Legality and Venture Governance Around the World*, 25 J. Bus. Venturing 54 (2010), *available at* http://ssrn.com/abstract=1611366; Josh Lerner & Antoinette Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, 120 Q. J. Econ. 1 (2005).

73. *See* William L. Megginson, *Towards a Global Model of Venture Capital?*. 16 J. of Applied Corp. Fin. 89, 95 (2004).

74. Ribeiro et al., *supra* note 31, at 2 (citing William L. Megginson, *Toward a Global Model of Venture Capital?*, 16.1 J Applied Corp. Fin. 89, 106 (2004)).

75. *Id.*

76. *Id.*

77. *Id.*

legal system.[78] Conversely, in countries with poor legal systems, investors discount the prices of firms to offset the risk of expropriation.[79]

Brazil ranks 82nd worldwide for investor protection, according to the International Finance Corporation and World Bank's Doing Business Project, which measures protection of investors by looking at extent of disclosure, director liability, and ease of shareholder suits.[80] Of the BRIC countries, Brazil came in second for shareholder protection, lagging considerably behind India (49th) but offering more protection than both China (100th) and the Russian Federation (117th).[81] Regionally, Brazil had more protections than some Latin American countries including, Venezuela (181st), and Argentina (117th); but much less than others, including Mexico (49th), Peru (13th), and Colombia (6th).[82] Colombia, the regional winner for investor protection, is tied with the United States.[83]

Brazil should do more to encourage investor protection in order to encourage the development of a vibrant private equity industry, and should strive to be a leader in Latin America, like Colombia and Peru. A comprehensive discussion about ways to improve investor protection in Brazil is beyond the scope of this note, but Brazil could consider increasing disclosure requirements, imposing more director liability for key transactions, and making it easier for shareholders to bring suits against public companies.

With increasing investor protection, Brazil must improve its legal system by increasing the predictability and efficiency of its judiciary. In 2004, the Economist complained that "Brazil's judiciary is dysfunctional: agonisingly slow, beset with frivolous cases designed to evade justice and enmeshed in useless procedure."[84] That year, Brazilian president Luiz Inácio Lula da Silva passed legislation to reform the judiciary called the First Republican Pact ("First Pact").[85] Through the First Pact, Brazil attempted to streamline the procedures for working issues through the judiciary, and Constitutional Amendment 45, created the National Council of

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78. Ribeiro et al., *supra* note 31, at 2 (citing Josh Lerner & Antoinette Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, 120(1) Q. J. Econ. 223, 240 (2005)).

79. Ricardo P.C. Leal & André L. Carvalhal-da-Silva, *Corporate Governance and Value in Brazil (and in Chile)*, *in* Investor Protection and Corporate Governance: Firm Level Evidence Across Latin America 213, 276 (Alberto Chong & Florencio de Silanes eds., 2007).

80. *Protecting Investors*, Doing Business, http://www.doingbusiness.org/data/explore topics/protecting-investors (last visited Feb. 13, 2013).

81. *Id.*

82. *Id.*

83. *Id.*

84. *Brazil's Judiciary: Not-So-Swift Justice*, The Econ. (March 27, 2004), http://www.economist.com/node/2542089.

85. Eduardo Soares, *Brazil: Reform of the Judiciary*, Library of Cong. (April 24, 2009), http://www.loc.gov/lawweb/servlet/lloc_news?disp3_l205401233_text.

Justice and the position of Secretary of Judicial Reform.[86] The First Pact also gave the agency power to design and implement reforms.[87] In 2009, the Second Republican Pact introduced additional measures aimed at judicial reform, including changes to the process for interlocutory appeals, aimed at speeding up the long process of reaching a final decision in Brazil, and improving uniformity in judgment and sentencing procedures throughout the country to reduce the uncertainty associated with going to court.[88] In 2011, a Third Republican Pact ("Third Pact") was proposed and scheduled to be signed by the end of May 2011.[89] Signing was pushed off until August 2011, when talks stalled.[90] Soon after, all negotiations came to a halt. Then, on January 8, 2013, the Minister of Justice met with the President of the Supreme Federal Tribunal to discuss an effort to restore negotiations for the Third Pact in hopes of passing it in 2013.[91] The Third Pact aims to combat problems related to Brazil's prison system and security.[92] In tandem with these reforms, São Paulo and Rio de Janeiro created specialized business courts. However, the São Paulo court is limited to bankruptcy and financial restructuring, and critics claim that the judicial process remains slow, and that judges suffer from a lack of expertise related to corporate issues.[93]

While these reforms are a step in the right direction, more needs to be done. Brazil's legal system is still described as "among the world's most convoluted," and critics point out that the "administration of justice is slow and cumbersome."[94] While a comprehensive discussion on judicial reform is beyond the scope of this note, Brazil should work to improve the certainty and expediency of its judiciary as it relates to investor claims.

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86. *Republican Pact: Partnership Among the Three Branches of the State at the Service of Democracy*, Supremo Tribunal Federal, http://www2.stf.jus.br/portalStfInternacional/cms/verConteudo.php?sigla=portalStfDestaque_en_us&idConteudo=174050.

87. *Id.*

88. *Id. See also* Débora Zampier, *Terceiro Pacto Republicano Será Assinado em Agosto,* Agencia Brasil (July 9, 2011, 5:50 PM), http://agenciabrasil.ebc.com.br/noticia/2011-07-09/terceiro-pacto-republicano-sera-assinado-em-agosto.

89. *Id.*

90. *Id.*

91. Wanessa Rodrigues, *Ministro da Justiça Discute III Pacto Republicano com Presidente do STF*, Rota Jurídica (Jan. 9, 2013), http://www.rotajuridica.com.br/index.php/stf/item/1671-ministro-da-justi%C3%A7a-discute-iii-pacto-republicano-com-presidente-do-stf

92. *Id.*

93. Black et al, *The Corporate Governance of Privately Controlled Brazilian Firms* (Cornell Legal Studies Research Paper No. 08-014), *available at* http://ssrn.com/abstract=1003059.

94. Kate O'Sullivan, *Brazil is Booming (and Maddening)*, CFO Magazine (July 15, 2010), http://www.cfo.com/article.cfm/14508833; PricewaterhouseCoopers, Doing Business and Investing in Brazil at 19 (2005), http://www.pwc.com.br/pt/publicacoes/assets/doing-business-brazil05.pdf.

2. Brazil should increase enforcement actions to improve the regulatory environment

Instituting quality regulatory systems that impose not only regulations but also consequences for rule-breakers encourages private equity activity by giving investors confidence that the rules of the game are certain.[95] In countries that bring more enforcement actions against private equity and venture capital funds, investors put more money in high-tech small and medium enterprises, exit more often through IPOs over buybacks, and generally achieve higher rates of returns.[96] Conversely, poor regulatory environments negatively affect private equity investment.[97] In countries with weak regulatory enforcement systems managers are more likely to buy controlling stakes in the company (so as to maximize their own control and oversight), creating possible conflicts of interest for minority shareholders.[98]

For these reasons, Brazil should take an active regulatory approach that encourages enforcement actions against rule-breakers. Before addressing which regulatory issues Brazil should tackle, however, it is important to discuss the regulatory entities that Brazil should rely on to set and enforce regulations.

D. *Which actors are best suited to set and enforce policies related to private equity: government agencies or self-regulating associations?*

Implicit in any discussion of regulatory choice is the question of which entities are best suited to make and enforce regulatory policy. As discussed in *Private Equity in Brazil*, both the Brazilian government and self-regulatory agencies currently set regulations for private equity players in Brazil.[99] In this section, I argue that neither the Brazilian government, via the Brazilian Securities and Exchange Commission ("CVM"), nor the self-regulatory agencies that purport to impose rules on private equity players do a sufficient job of setting and enforcing regulations.

1. The Brazilian government, through the CVM, does not adequately set and enforce regulations

The Brazilian Government relies on the CVM to oversee a private equity fund's basic registration and to review any warranties it plans to make to investors.[100] In this way, the CVM essentially stands as a gate-keeper

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95. Ribeiro et al., *supra* note 31, at 2 (citing Douglas J. Cumming & Jeffrey G. MacIntosh, *A Law and Finance Analysis of Venture Capital in Emerging Markets* (2002) (unpublished working paper, on file with University of Alberta).

96. *Id.*

97. *Id.*

98. *Id.*

99. *Private Equity in Brazil*, *supra* note 1, at 160.

100. *Id.*

for entrance into the private equity market.[101] However, entrance is easy and registration is granted automatically provided certain criteria are met.[102] In reality, the CVM does not begin to pay close attention to private equity activities until the funds purchase shares on the Brazilian stock markets, or take their portfolio companies public through an IPO.[103] The general justification for this policy is that these markets pose much greater risks to the well-being of the financial system as a whole than do the activities of sophisticated investors working with privately-held companies.[104]

Although the CVM works to maintain two explicit goals for protecting investors and financial information access. The CVM articulates these goals as (1) seeking to "monitor the information divulged about investment funds in order to foment an environment of trust among investors in the market stemming from the availability of appropriate information, which enables investors to make conscious and informed decisions;"[105] and (2) seeking to monitor "the administration and management of investment funds, so as to promote the development of an environment of credibility in the market through management that emphasizes technical skills, poise, diligence, transparency, and independence of professionals."[106]

While these goals are laudable, the two objectives go only so far as to make the market *appear* credible as opposed to striving for *actual* credibility. Understandably, the CVM's focused on investor confidence must not be trivialized. The importance of investor confidence is crucial to the functioning of a capital market that relies on investors' confidence. However, the CVM should not tailor its supervision policies only to the specific goal of improving the market to cater to the confidence of investors. The CVM should direct its activities to improving the long-run accountability of the actual institutions and markets themselves. Doing so will ensure the health and sustainability of the market and will naturally improve investor confidence and perpetuate investment and activity in the market.

Given CVM's narrow policy goals, the agency itself is not poised to take an active enough regulatory role to ensure high quality levels of private equity activity in Brazil. The following discusses some other regulatory organizations that may help improve quality control in the country's private equity market.

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101. *Id.*

102. *Id.*

103. *Id.*

104. *Id.*

105. Comissão de Valores Mobiliários [CVM], Supervisão Baseada em Risco (SBR), Plano Bienal 2011-2012 [Risk Based Supervision, Biennial Plan 2011-2012], 34 (2011), http://www.cvm.gov.br/port/public/publ/revista/Plano%20Bienal%20CVM%202011-2012.pdf [hereinafter CVM Biennial Report].

106. *Id.*

2. Self-regulatory agencies that purport to set and enforce regulations do so ineffectively and suffer from conflicts of interest

Three non-government self-regulatory associations provide what purports to be additional oversight and protection for Brazilian investors: (1) The Brazilian Association of Entities in the Financial and Capital Markets (*Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais,* or "ANBIMA"); (2) The Brazilian Association of Private Equity and Venture Capital (*Associação Brasileira de Private Equity e Venture Capital* or "ABVCAP"); and (3) BM&FBOVESPA, the São Paulo Stock Exchange. As discussed in *Private Equity in Brazil*, each of these organizations is independent of the Brazilian government, privately run, and purports to set and enforce regulations on those who participate in them.[107] In this section, I argue that these agencies have too many conflicts of interest and are not independent enough to succeed at setting and enforcing private equity regulations in Brazil.

a. *ANBIMA and ABVCAP's Code of Regulations for private equity is insufficient*

ANBIMA is an association comprised of market participants that aims to promote members' interests and brands in addition to providing internal self-regulation among members.[108] Similarly, ABVCAP is a non-profit organization that strives to promote the growth of private equity and venture capital in Brazil. Together, these two self-regulators recently released a code that provides best-case practices and enforcement mechanisms for all those who choose to adhere to its rules.

Since the ANBIMA and ABVCAP code is less than a few years old, it is impossible to determine the exact affect the regulations will have on encouraging quality private equity activity in Brazil. However, it is useful to evaluate the stated goals of the code in order to evaluate its potential for improving the private equity environment in Brazil. Article 1 of ANBIMA and ABVCAP's Code for the Regulation and Best Practices [sic] of Private Equity and Venture Capital Funds, establishes that the Code's purpose is to:

> Establish the parameters that should serve to guide the activities of the Participating Institutions. . .as regards the creation and modus operandi of Private Equity Funds . . .for the purpose, principally of: I. ensuring transparency in the execution of their activities, making it easier to quantify and monitor the development of the sector; II. enabling the standardization of their practices and processes; III. contributing towards their credibility and proper functioning; IV. maintaining the highest possible ethical standards and institutionalizing the concept of fair practices; V. raising fiduciary standards and furthering best market practices; and VI. promoting, to the extent possible, the harmoniza-

107. *Private Equity in Brazil*, *supra* note 1, at 160-62.

108. *Id*. at 161-62.

tion and gradual integration between the Brazilian market for FIPs/FIEEs and the international private equity and venture capital markets.[109]

The code contains extensive rules and best-case practices, which are binding on members affiliated with either ABVCAP or ANBIMA, and members who agree to abide by its terms. In exchange for following the rules of ANBIMA's code, private equity funds can place on their documents a seal indicating that they adhere to the Code. Notably, Chapter XX titled, "Procedures for Investigating Irregularities," states that the Technical Department, a department created within the two organizations "shall investigate any cases of non-compliance with the provisions of this Code upon its own initiative or upon receipt of a complaint."[110] However, "only complaints presented by Participating Institutions shall be accepted."[111] In other words, individuals may not bring a complaint for investigation before the Technical Department - only participating institutions may do so. Once the Technical Department investigates a complaint and finds a code violation, the Department is not required to take particularly harsh enforcement actions against the party for violating the code. Article 60 of the Code makes clear that "[w]here the infraction is found to offer little potential damage and [can be] easily remedied," the Technical Department may simply issue a recommendation, upon concurrence from the Chairman of the Regulation and Best Practices Board, that outlines how the entity can come back into compliance with the code.[112] Such "enforcement action" is nothing more than a slap on the wrist and does nothing to remedy the loss suffered by harmed parties. The following paragraph in Article 60 states that the Regulation and Best Practices Board may relax this standard even further by promulgating a regulation that allows the Technical Department to issue such a recommendation without even the concurrence of the Chairman, effectively eliminating the Technical Committee's second layer of review.[113]

These relaxed enforcement provisions are justified on the grounds that, by their terms, they apply only to de minimis infractions, or infractions "found to offer little potential damage and [are] easily remedied."[114] However, the code offers no discernible standard for determining when an infraction is de minimis, nor does it identify the department responsible for making such determinations. Accordingly, these provisions offer wide latitude for abuse within what is merely a voluntary regulatory regime, and

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109. ABVCAP-ANBIMA, Regulation Best Practives Code Private Equity And Venture Capital Funds art. 1, at 3, *available at* http://portal.anbima.com.br/fundos-de-investimento/regulacao/codigo-fip-fiee/Documents/Code%20-%20ANBIMA%20ABVCAP.pdf.

110. *Id*. art. 56, at 25.

111. *Id*.

112. *Id.* art. 60, at 26.

113. *Id.* at 27.

114. *Id.* at 26.

present a clear opportunity for regulatory arbitrage by the joining members.

On the other hand, there may be several positive benefits associated with the Code. First, allowing Private Equity funds to *choose* whether to participate in the Code can present a more efficient way of promoting participation than attempting to force change through a cumbersome process of government regulatory reform.[115] It may also be cheaper for the Brazilian taxpayer, since ANBIMA and ABVCAP are privately funded. Further, a large portion of private equity and venture capital firms are already subject to the code, since many had joined ANBIMA and ABVAP already. Private equity funds that subject themselves to stricter rules signal to national and international investors that the institutions are committed to acting with integrity.

Additionally, since instances of noncompliance are publicized, and since non-complying entities must remove the ANBIMA-ABVAP seal from their investor documents, which could trigger investor flight, competing funds have an incentive to raise noncompliance complaints against a non-compliant peer. In other words, subscribing funds may have an incentive to police each other and an incentive to regulate their own internal operations in order to comply with the code and preserve their reputation.

The ABVCAP code is probably a step forward to achieving improvements in its stated goals, including helping to promote transparency, preventing conflicts of interest, protecting investors, and helping improve data collection related to the industry. The code's mere existence and the associational nature may encourage compliance in ways that are hard to quantify. However, on balance, the self-regulatory nature of the code raises several red flags for those who believe that maintaining a high quality of regulation is imperative to ensuring the integrity of the equity markets and the private equity industry generally. The SEC has described some of the many problems inherent with self-regulatory organizations as follows:

> Pressures that inhibit effective regulation and discourage vigorous enforcement against members can arise for a variety of reasons, including member domination of SRO funding, member control of SRO governance, and member influence over regulatory and enforcement staff. In addition, the economic importance of certain SRO members may create particularly acute conflicts.[116]

115. *See* Ronald J. Gilson et al., *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the U.S., and the EU* (Stanford Law and Econ. Olin Series, Working Paper No. 390; Columbia Law and Econ. Working Paper No. 368; Yale Law and Econ. Research Paper No. 399; ECGI - Law Working Paper No. 149/2010; Rock Center for Corp. Governance at Stanford U. Working Paper No. 80, 2010), *available at* http://ssrn.com/abstract=1541226.

116. Concept Release Concerning Self-Regulation, 69 Fed. Reg. 71256 (proposed Dec. 8, 2004) (to be codified at 17 C.F.R. pt. 240), *available at* http://www.sec.gov/rules/concept/34-50700.pdf.

The nature of enforcement under the code seems to suffer from some of these flaws. The code resembles little more than a "window dressing" that does not provide any actual regulatory substance. The code is advanced by an institution that styles itself as a representative of the institutions it purports to police. This signals important agency and conflicts of interest issues: how can ANBIMA be both a representative of, for example, private equity firms and also attempt to be an impartial promoter of best practices? The nature of the code's development, in which regulated entities contribute to the code's rules, also raises questions about the impartiality of the rules themselves. While it may be good to obtain input from the regulated entities, these same entities likely have incentives to push for rules that make them look good in the eyes of international investors, but which impose minimal burdens on the entities themselves, even if more burdens would be better for "the system." Further, without an impartial regulator, the only interests represented at the negotiating table are those of the regulated entities themselves, not consumers, investors, taxpayers generally, or even the Brazilian government. Such unilateral rule-making invariably raises questions about who the real winners are in this scheme.

Since the ANBIMA-ABVCAP code is still young, only time will tell whether it turns out to be an effective regulatory mechanism. If the self-regulatory agencies ANBIMA and ABVCAP actually insist on enforcing violations related to the code and make such enforcement mechanisms known, as opposed to just serving as a nominal regulator for the benefit of the funds' illusory credibility, it will send very positive messages to the international investment communities that Brazil has struck a responsible balance between self-regulation and governmental oversight. In many ways, if ANBIMA and ABVCAP were to make an early example out of some fund that violates the code, it would add legitimacy to the regulatory nature of the organization. Until this happens, and happens with some consistency, the balance of self-regulatory mechanisms and governmental regulation appears tipped too far in the realm of subjective self-regulation as opposed to credible and objective government enforcement. In order to ensure that the Brazilian private equity industry remain reputable, additional government oversight of the industry, beyond ANBIMA and ABVCAP is advised.

b. *BM&FBOVESPA's self-regulatory regime is insufficient*

As discussed in *Private Equity in Brazil*, BM&FBOVESPA, the São Paulo Stock Exchange, attempts to impose some regulations on private equity investments when these exit through an initial public offering, listed on the exchange.[117] Gilson has argued that the stock exchange, by giving listing companies the option of voluntarily listing on the *Novo Mercado* segment, which imposes higher corporate governance standards, has pro-

117. *Private Equity in Brazil*, *supra* note 1, at 160.

vided positive benefits to the integrity of the Brazilian capital markets.[118] For Gilson, the problems with enacting extensive reforms in countries, like Brazil, which are controlled by an entrenched elite, is that the individuals in control have very little incentive to reform existing regulations, because they ostensibly benefit from the current regime.[119] By giving companies the option, but not obligation, to voluntarily submit to higher corporate governance standards, BM&FBOVESPA uses the technique of regulatory dualism (two choices of regulations), and overcomes some of the political problems associated with comprehensive reform.[120]

While BM&FBOVESPA claims to impose higher standards of corporate governance for companies that list on its exchanges, some data suggests that corporate governance standards, even among companies that list on the *Novo Mercado* segments, remains relatively weak.[121] In a study of 88 Brazilian private firms listed on the stock exchange, Black, Carvalho, and Gorga found that one area of regulatory weakness is the lack of enforcement to ensure the independence of a funds' board compositions.[122] The study found that most boards are run by insiders or representatives of the controlling family or group who owns the fund.[123] It is common for boards not to have any independent directors.[124] Additionally, BM&FBOVESPA's enforcement of its financial disclosure standards are relatively weak compared to international enforcement over financial standards.[125] According to the 2005 data, firms listed at higher segments of the BM&FBOVESPA stock exchange were required to disclose additional financial statements, such as cash flow statements, IFRS or GAAP financials.[126] English disclosures, and consolidated quarterly financial

118. *See generally* Ronald J. Gilson et al., *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the U.S., and the EU* (Stanford Law and Econ. Olin Series, Working Paper No. 390; Columbia Law and Econ. Working Paper No. 368; Yale Law and Econ. Research Paper No. 399; ECGI - Law Working Paper No. 149/2010; Rock Center for Corp. Governance at Stanford U. Working Paper No. 80, 2010), *available at* http://ssrn.com/abstract=1541226.

119. *Id.* at 6.

120. *Id.*

121. *See generally* Bernard S. Black et al., *The Corporate Governance of Privately Controlled Brazilian Firms* (U. of Texas Law, Law and Econ. Research Paper No. 109; Cornell Legal Studies Research Paper No. 08-014; ECGI - Finance Working Paper No. 206/2008, 2009), *available at* http://ssrn.com/abstract=1003059.

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. Brazil began requiring the use of International Financial Reporting Standards for all listed companies and large financial institutions in 2010. *See* Ernst & Young, *IFRS in Brazil – Spotlight on Brazil's IFRS Adoption*, IFRS Outlook, March 2012, at 6, http://www.ey.com/Publication/vwLUAssets/IFRS_Outlook_-_March_2012/$FILE/IFRS%20Outlook%20March%202012.pdf.

statements, depending on the level of listing.[127] However, not all companies complied with these standards, and no action was taken to enforce disclosures.[128]

Donegá points to a number of issues that undermine the credibility of BM&FBOVESPA as an effective self-regulatory organization. BM&FBOVESPA's Market Surveillance organization (*BM&FBOVESPA Supervisão de Mercados*, or "BSM") is an independent body from the stock exchange. However, Donegá argues that it is only relatively independent and therefore not completely free from agency capture.[129] First, he notes that the BSM is subjected to the Brazilian Securities and Exchange Commission's ("CVM's") supervision; and though it has its own budget, staff, expertise, and resources, there is no mention of its structural independence from CVM.[130] Further, BSM is not *administratively* independent, because BM&FBOVESPA holds 99 percent of BSM shares, and the Bank of BM&F Settlement and Custody Services, S.A., holds 1 percent.[131] Finally, approximately one third of BM&FBOVESPA's capitalization comes from foreign investors, who may not have the proper incentives to increase regulation.[132] These issues raise serious questions about the ability of the Stock Exchange to be an impartial regulator. More recent data related to BM&FBOVESPA's efficacy as a self-regulatory organization is lacking, but the data that is available suggests that the exchange, acting alone, does not do a sufficient job setting and enforcing regulations.

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The apparent inefficiency of the CVM and self-regulatory organizations means that Brazil needs to consider either increasing enforcement at the CVM or realigning the incentives of the self-regulatory organizations to ensure better enforcement. While this paper points to the issues inherent in the Brazilian private equity market's current self-regulatory regime, a comprehensive solution to its weaknesses is beyond the scope of discussion here. In the next section, I turn from examining the market's private self-regulatory regimes and look at Brazil's government regulations. I ask what sorts of risks Brazilian regulators should focus on, and attempt to analyze the efficacy of current regulation.

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127. Raul Pinheiro Donegá, *Analyzing Cross Border Investment Opportunities and Mechanisms of Investor Protection: A Case Study of BM&F BOVESPA* 14-5 (Univ. of B.C., Working Paper No. K22, 2010), *available at* http://ssrn.com/abstract=1595887.

128. *Id.* at 15.

129. *Id.* at 17.

130. *Id.*

131. *Id.* at 18-19.

132. *Id*. at 5.

III. Critique: What Sorts of Risks Should Brazilian Regulators Worry About and How Effectively Do They Appear to Be Addressing Each Risk

In this section, I identify major risks that have been linked to private equity transactions and I assess whether Brazil is effectively guarding against each risk. To define risks posed by private equity, I rely on two key reports: the International Organization of Securities Commissions' ("IOSCO") *Final Report on Private Equity,* and the CVM's Biennial Supervision Plan. First, IOSCO's *Final Report on Private Equity* lays out general risks posed by private equity markets throughout the world, evaluates whether or not each risk relates to IOSCO's three objectives of securities regulation and recommends additional studies related to specific risks be undertaken, as needed.[133] Second, the CVM's 2011-2012 Biennial Supervision Plan is mandated by CVM Deliberation No. 521/07, which requires the CVM to release a report every two years that reviews its work in regulating the Brazilian private equity market.[134] The report reviews four regulatory indicators specifically: (1) the "general actions" that the CVM must take to ensure it complies with its legal mandate and enumerated goals; (2) the "risk events" that the CVM believes threaten its goals, classified in terms of probability of occurrence and the potential for harm should they occur; (3) the priority actions for regulation and supervision to adopt in the coming two years in order to mitigate the identified risks, including detailed and specific actions to be taken; (4) the discretionary activities, or measures that the CVM *might* adopt if there are compelling reasons.[135] After classifying risks by probability of occurrence and potential harm, the CVM allocates most of its resources to combating higher risk activities.[136] By scrutinizing the CVM's latest report, which appears to be the most topical evaluation from the Brazilian Government of its own view of private equity risks, I assess the progress of Brazil's regulators at combating areas of known risk.

In this section, I compare Brazil's assessment of risks against those risks identified by IOSCO in order to determine whether the international and national regulator's share similar regulatory objectives. While the question of whether Brazil's regulators are actually working to minimize risks and meet their objectives is beyond the scope of this note, this section analyzes whether Brazil is on the right track to managing risks within its private equity industry, or if other risks, common to private equity markets, are issues which Brazil should address. Careful management of these risks will improve the strength and reputation of Brazil's private equity industry. .

133. Int'l Org. of Sec. Comm'n, Private Equity Final Report 36 (2008), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD274.pdf [hereinafter IOSCO].

134. CVM Biennial Report, *supra* note 105.

135. *Id*.

136. *Id.*

A. *Private equity generally generates risks related to increased leverage in capital markets, but this is not a risk that Brazil needs to worry about at present*

A private equity market can significantly increase leverage in capital markets where leveraged buyouts are common, but this places significant pressure on companies to service their debts and would most likely cause harm to both public and private markets if very large firms defaulted.[137] When an institution is highly leveraged, pro-cyclicality can be amplified.[138] This means that if investor confidence dissipates and the value of collateral securities falls, highly-leveraged institutions may experience abrupt de-leveraging and may need to conduct a fire sale, resulting in massive losses to investments.[139] IOSCO found that issues related to increasing leverage were relevant to the IOSCO objectives of increasing investor protection and decreasing systemic risk.[140] The Technical Committee recommended that IOSCO's Joint Forum, a subcommittee, conduct a large-scale survey to measure leveraged buyout activity across member jurisdictions.

As mentioned in *Private Equity in Brazil*, LBO-like acquisitions are virtually non-existent in Brazil, due to the high cost of debt, which largely eliminates the traditional concern about systemic risk related to leverage.[141] Not surprisingly, then, Brazil's regulators have not voiced any concerns about the risk of high leverage in their private equity regime.

Given the near-complete lack of leverage in the Brazilian private equity markets, this major risk posed by private equity in other parts of the world need not be addressed by Brazilian regulators at present. Still, should LBOs become more common in Brazil's future, Brazilian regulators should pay close attention to the potential for systemic risk caused by large amounts of leverage.

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137. *Id.* at 10.

138. *See* Jennifer Payne, *Private Equity and its Regulation in Europe*, 14 (Univ. of Oxford, Paper No. 40/2011, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1886186.

139. *Id.*

140. IOSCO, *supra* note 133, at 14.

141. *Private Equity in Brazil*, *supra* note 1, at 183. By contrast, these transactions should be of large concern to American and European private equity regulators, because of the large number of LBOs conducted in those markets. Still, some commentators suggest that because portfolio-companies are generally not cross-collateralized in leveraged buyout transactions, even if one company fails the threat of knock-on effects for other funds and portfolio companies within the same fund is minimal. Payne, *supra* note 138, at 15. Further, it's possible that no negative externalities would result even if a private equity fund did need to perform a fire sale, because its assets are largely heterogeneous, and exposure to particular risks is minimized because private equity funds diversify their portfolios by investing in many industries. *Id.*

B. *Private equity transactions present the potential for market abuse problems and Brazil should pay particular attention to this risk due to high levels of corruption*

Private equity creates potential market abuse problems in capital markets because sensitive price information flows constantly between parties and generally increases with the complexity of the transaction. Jurisdictions that do not have market abuse oversight mechanisms may face investor confidence issues, which leads to less capital in the system.[142] IOSCO found that market abuse risks were relevant for the IOSCO objectives of increasing investor protection and promoting fair and efficient markets.[143] The Technical Committee emphasized that market abuse and fraud prevention measures remained key priorities for IOSCO's work, but did not mandate any additional IOSCO work to be done towards combating these threats.

Brazil's CVM identified some risks related to market abuse problems in its Biennial Report. One of the CVM's goals is to "monitor[ ] the administration and management of investment funds, so as to promote the development of an environment of credibility in the market through management that emphasizes technical skills, poise, diligence, transparency, and independence of professionals."[144] In keeping with this goal, the CVM noted that the presence of untrained Brazilian "managers and directors that lack the appropriate policies regarding internal controls, compliance with regulation, routine risk management, and prevention of money laundering," was one risk threatening Brazil's private equity market.[145]

The CVM also monitors "the information divulged about investment funds in order to foment an environment of trust among investors in the market stemming from the availability of appropriate information, which enables investors to make conscious and informed decisions."[146] Pursuant to this goal, however, the CVM found that "the existence of funds whose activity and regulations do not fully adhere to current legislation," was another identifiable risk that could undermine Brazil's private equity market.[147]

Notably, the CVM, in keeping with its goals, successfully identified the potential for market abuse and made sure that prevention of market abuse is a stated regulatory goal. It is difficult, however, to evaluate the actual efficacy with which the CVM has pursued its goal and the actual level of threat posed by private equity in this area, because the CVM does not make these enforcement decisions public. The downside of making information related to market abuse public is that it would undermine confi-

142. IOSCO, *supra* note 133, at 10.

143. *Id*. at 14.

144. CVM Biennial Report, *supra* note 105, at 33.

145. *Id.* at 40, 46.

146. *Id*. at 33.

147. *Id*. at 41.

dence in capital markets, which is one of the CVM's explicitly stated goals. On the other hand, publicizing known market abuses might also encourage companies to take heed of the types of abuses they too should internally monitor and to institute procedures that curb any such market abuse. Intuitively, it makes sense that market abuse might be one of the greatest threats posed by the Brazilian private equity industry. Corruption is a persistent problem in Brazil. Transparency International's 2012 corruption perceptions index ranked Brazil 69th out of 176 countries around the world for perceived levels of public sector corruption.[148] While data on actual corruption is hard to gather, this suggests that many people believe that corruption persists in Brazil, which works in favor of increased regulation to combat corruption and market abuses.

C. *Private equity transactions can generate conflicts of interest risks and these risks may be particularly salient in Brazil due to high levels of corruption*

Material conflicts of interest can pose risks to investor confidence in capital markets when parties take on multiple roles in the same transaction or when a party engages in both advisory and proprietary activities. For example, in management buy-outs, when management buys control of the company, that management has both a fiduciary duty to current shareholders to recommend the highest sale price and a self-interested motive to recommend the lowest sale price, leading to conflicts of interest.[149] IOSCO found that conflicts of interest risks operate against its objectives of increasing investor protection and promoting fair and efficient markets.[150] The Technical Committee recommended further work to develop principles for combating conflicts of interest in public-to-private and private-to-public private equity transactions insofar as those transactions pose risk to public investors.[151]

The CVM also identified a "lack of practices designed to prevent and manage conflicts of interest when these occur between funds and their directors or managers" as a risk event in its Biennial Report.[152] As a result, it recommended regular enforcement actions for investment funds generally to guard against conflicts of interest violations. Even though data related to these enforcement actions is unavailable, it is commendable that the CVM has articulated its intention to focus on this potential risk area. It is impossible, however, to conclude how effective the CVM has been at actually guarding against potential conflicts of interest.

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148. *Corruption Perceptions Index 2012*, TRANSPARENCY INT'L., http://www.transparency.org/cpi2012/results (last visited March 20, 2013).

149. IOSCO, *supra* note 133, at 10.

150. *Id*. at 14-15.

151. *Id*. at 18-19.

152. CVM BIENNIAL REPORT, *supra* note 105, at 47.

D. *Private equity can pose risks related to transparency and Brazil should focus on mitigating these risks*

Transparency risks may exist in private equity transactions, in spite of the fact that private equity investors generally receive substantial disclosure from firms. Valuation and performance reporting varies across jurisdictions, which can make it hard for investors to compare investments and optimize investment strategies and might undermine investor confidence in private equity firms.[153] IOSCO's Private Equity Final Report found that minimizing transparency risks were also relevant for the IOSCO objectives of increasing investor protection and promoting fair and efficient markets.[154] Additionally, the report emphasized that curbing such risks should be an ongoing priority for both IOSCO and national regulators, but that additional IOSCO work related to transparency and private equity was not necessary at the time of the report.[155]

In line with IOSCO's recommendations, the CVM specifically identified transparency as a risk in its Biennial report. While no mention was made of conformity with other jurisdiction's valuation methods, the CVM thought that "the availability of funds whose assets are valued in ways that are not in conformity with the existing legislation or, when relevant, the valuation standards set out in the fund's regulation [the document establishing the fund]" was a risk.[156] Again, it is hard to judge whether the CVM is actually doing a reasonable job guarding against transparency concerns. However, they have at least brought their stated regulatory goals in line with those recommended by IOSCO, which is commendable.

E. *Private equity may pose risks to overall market efficiency, but such broad risks are difficult to define and regulate and Brazil need not focus on these risks*

Private equity can pose complex issues related to overall market efficiency. Arguably, private equity firms that take once publicly traded companies off market essentially enjoy the benefits of owning the company during a high-growth period, which might otherwise be enjoyed by regular investors if the company had remained public. Some jurisdictions could suffer from having a large private equity market if the existence of such a market undermines the quality of public markets.[157] IOSCO found that overall market efficiency risks did not fall within any of IOSCO's mandates of risks to monitor[158] and limited its recommendation to an observa-

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153. IOSCO, *supra* note 133, at 11.

154. *Id*. at 15.

155. *Id*. at 19.

156. CVM Biennial Report, *supra* note 105, at 44.

157. IOSCO, *supra* note 133, at 11.

158. *Id*. at 15.

tion that individual national public bodies might need to consider issues related to market efficiency when designing regulatory policies.[159]

Unsurprisingly, the CVM did not identify any risks related to overall market efficiency in its assessment of risks in its Biennial Report. Any such generalized design question is better left to the *Conselho Monetario Nacional*, Brazil's norm-setting body that governs monetary policy generally. The internal discussions of this entity are not widely available, but it is likely that Brazil's regulators consider overall market efficiency while designing their policies. Due to the broad and somewhat undefined nature of this particular risk and the lack of information related to Brazil's monetary policy-setting-body, I am unable to assess the adequacy of Brazilian regulator's efforts towards controlling general market efficiency, and such an assessment is beyond the scope of this note.

F. *Private equity may generate market access risks, but Brazil's regulators need not focus on these risks at this time*

Even though most private equity transactions are limited to qualified investors, market access problems may arise if private equity firms have retail exposure through certain activities. For example, a private equity firm might offer hybrid securities to retail investors in a given transaction. IOSCO found that risks related to market access were relevant to IOSCO's objective of increasing investor protection,[160] but that because the number of retail investments in private equity funds is generally small it was not appropriate to mandate additional work related to mitigating this risk.[161]

Brazil's regulators have not voiced any opinion on market access risks. Research does not reveal any mechanisms by which Brazilian private equity firms would have exposure to a combination of both retail and private investors. Assuming that such practices do not exist in Brazil, I conclude that Brazil's regulators need not be concerned about market access risks at this time.

G. *The private equity industry has the potential to pose systemic risks to capital markets but does not pose such risks in Brazil at this time*

Possibly the most important goal of financial regulation is to avoid the concentration of risk in systemically important institutions which engage in risky financial activities that—if they fail—threaten the integrity of the financial system as a whole. This type of risk, systemic risk, has become a pressing concern in light of the recent financial crisis.

Institutions may pose systemic risk if, when many of the institutions investors attempt to redeem their investments simultaneously, there is a "run" scenario and the institution is forced to conduct a fire sale to meet

159. *See id*. at 12.

160. *Id*. at 15.

161. *Id*. at 20.

its obligations. Commentators have argued that private equity funds do not pose this type of systemic risk due to the long-term nature and illiquidity of the private equity investment. In *Private Equity and its Regulation in Europe*, Jennifer Payne argues that private equity funds and hedge funds are distinguishable in that hedge funds have the potential to cause credit crunches while private equity funds do not.[162] Hedge fund investors, Payne explains, can cash in their investment with a 90-days notice. If a large number of investors ask for redemptions at the same time, the fund might be forced to sell companies in a down market to honor redemptions. Private equity fund investors, on the other hand, may not withdraw their capital before the fund matures, typically for a period of ten years, leading to a reliance on long-term capital commitments as opposed to short-term financing, and less susceptibility to runs.[163] Like the U.S. and European funds that Payne focuses on, Brazilian private equity funds are structured as closed-end investments that investors cannot redeem at any time. A typical investment horizon is about ten years. Accordingly, private equity funds in Brazil are similarly protected from the runs associated with systemic risk.

Other commentators have stressed that the private equity industry does not pose the traditional threats of systemic risk because investments are long-term and illiquid. These commentators contrast private equity funds with mutual funds, which contribute to systemic risk because investors may rapidly withdraw money if funds experience bad times. Commentators also stress the fact that private equity investments pose less systemic risk because limited partner's investments are not cross-collateralized, meaning that one form of collateral can be subject to multiple interests.[164]

The Private Equity Industry in Brazil does not appear to pose the sorts of systemic risk concerns that might be applicable in more developed private equity markets. Unlike the U.S. and European private equity markets, private equity deals in Brazil are financed almost exclusively through equity, so there are no leverage concerns associated with systemic risk. Moreover, Brazilian private equity funds are structured to avoid spontaneous funds redemptions by investors. Because private equity investments are limited to specific types of "qualified" investors that accept the funds' investment structures, there are fewer risks posed to normal retail investors.[165] For these reasons, I conclude that Brazilian regulators need not expend significant effort worrying about the systemic risks posed by private equity at this time.

162. Payne, *supra* note 138, at 14.

163. *Id.*

164. *See* Lapado Lawale Nicholas, *Private Equity In a Deleveraged Economy: Lessons From the Financial Crisis* 13 (May 18, 2010) (unpublished student article on file with Harvard Law School), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1628948.

165. *Private Equity in Brazil*, *supra* note 1, at 167.

H. *Private equity may theoretically pose risks to investors, even when they are qualified, but Brazil's level of investor protection is probably adequate as-is*

Brazil's regulators appear to be only minimally concerned with investor protections for private equity investors, even though "qualified" investors may also need protection. The CVM has relatively simple procedures for setting up a private equity fund, and provides little oversight of the fund while it is operating. Only if a private equity funds attempt to exit the strategic investment by taking the target company public does the CVM step in and take a more active supervisory role. This begs the question: why is there so little day-to-day supervision of private equity funds?

The main rationale for imposing less oversight over the day-to-day operations of Brazil's private equity funds is because investments in private equity funds are limited to qualified investors. Qualified investors are ostensibly sophisticated and in less need of protection than "mom and pop" investors, who are assumedly less financially savvy and in need of more governmental protection. Investor protection costs money to both the enterprise (which must pay to ensure compliance) and the taxpayer (whose taxes support rule-making and enforcement activities). Accordingly, policymakers do not wish to impose extra costs on the system if there is not a compelling reason to do so. The traditional "qualified investor vs. mom and pop investor" rationale for not regulating private equity fund activity rests on several assumptions that may be questioned.

First, a policy of less oversight over investments made by qualified investors assumes that possession of a certain amount of money (in Brazil's case a $100,000 *reais* investment and $300,000 *reais* in other investments) automatically makes a person or company a sophisticated investor in need of less protection.[166] However, wealth may not be a particularly good proxy for ability to assess financial risk. In Brazil, wealth is frequently passed from generation to generation through close family relationships, but financial savvy may not always be transferred from parent to child. Furthermore, using a high threshold of wealth as proxy for need of protection may underestimate the financial savvy of less wealthy Brazilian investors, imposing regulatory costs on the system that are inefficient. With numerous scholarship programs that allow poor Brazilians to pursue higher education, it is conceivable that many recent graduates are able to understand financial risk without making the cutoff of qualified investors. In addition, as with any bright line test, it is possible to question whether the line for "qualified" investors was drawn in the appropriate place—for example, why not decline to protect those who invest $75,000 *reais*?

All of these criticisms may be largely theoretical. Intuitively, financial savvy and need for protection probably is—in most cases—strongly correlated to wealth and quantity of investments. While different "cut-off"

166. CMV Instruction No. 391, *available at http://www.cvm.gov.br/ingl/regu/cvm_391.ASP.*

points are certainly possible, $100,000 *reais* is probably a decent predictor an investor's general ability to fend for himself. On the other hand, the rapid evolution of financial products may mean that even those investors that are particularly wealthy are in need of extra investor protection due to the complex nature of the transactions they undertake. In the U.S., the Financial Crisis Inquiry Commission found ample evidence that the investors involved in buying and selling complex financial instruments like Collateralized Debt Obligations (CDOs) and "CDO-squared" instruments, had very little understanding of the actual nature or underlying risks associated with those products.[167] These findings raise important questions about the traditional justifications for having two tiers of oversight for investors. Notably, CVM instruction 391 specifically limits a FIPs ability to invest in derivatives, with the exception of hedging against its own risks.[168] This limitation appears to be a step in the right direction towards protecting all investors, regardless of qualifications, when very complex financial instruments are involved. Overall, the amount of investor protection imposed by Brazilian regulators is a good thing. Given the important limitation on FIPs ability to invest in derivatives, even "qualified" investors are protected on some level, and imposing additional layers of investor protection would probably stifle growth in a high-growth, productive industry that (as already concluded) does not impose systemic risk to Brazil's financial system overall.

IV. Conclusion

In this note, I analyzed the policy choices that arise from the growth of Brazil's private equity market and questions Brazil's regulators must confront as they decide how to handle this increasingly important industry. I concluded that the Brazilian government should play a role in actively encouraging private equity in Brazil. After looking at several market factors, I concluded that Brazil has already started to encourage demand and supply for private equity funds. Notably, however, the government could encourage more private equity investment by reducing crippling interest rates, investing more in research and development, and easing the regulatory burdens associated with filing patent applications. I concluded that Brazil should take an active stance in regulating its growing industry, and that the CVM's "hands off" approach to regulation and the heavy reliance on self-regulatory agencies alone are probably insufficient to handle private equity regulation in the future. ANBIMA and ABVCAP, the authors of the new "Self-Regulatory Code" for private equity firms, and BM&FBOVESPA, the São Paulo Stock Exchange, have all made promising steps towards improving the regulatory climate in Brazil, but are too

167. *See* Fin. Crisis Inquiry Comm'n, Financial Crisis Inquiry Commission Report, xxiv, 8 (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

168. CMV Instruction No. 391, *available at* http://www.cvm.gov.br/ingl/regu/cvm_391.ASP.

riddled with conflicts of interest to stand alone as reliable independent regulators.

I found that some of the traditional risks posed by private equity, such as systemic risk, caused by high levels of leverage, are non-existent in Brazil at this time, because private equity deals in Brazil are financed almost exclusively with equity. Accordingly, I concluded that Brazil's national regulators need not worry about these risks unless the price of debt comes down and leverage increases. Instead, Brazilian regulators should focus on risks related to market abuse, conflicts of interest, and transparency, as these may be more salient in a country with high levels of corruption.

Brazil should celebrate the recent growth and success of its nascent private equity industry, and should take steps to allow private equity to flourish in the future. Reducing interest rates, increasing the predictability of the judiciary and the quality and accountability of regulators are first steps to making sure that private equity's future in Brazil remains bright.